Supreme Court, U.S.
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No. 96-1075

In The Supreme Court Of The United States

OCTOBER TERM, 1996

ERNST & YOUNG LLP, PETITIONER

v.

DOLLARD MCGANN, ON BEHALF OF HIMSELF AND ALL OTHERS SIMILARLY SITUATED, ET AL., RESPONDENTS

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

REPLY TO BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

MILES N. RUTHBERG
PAMELA S. PALMER
Latham & Watkins
633 West Fifth Street
Suite 4000
Los Angeles, California 90071

KATHRYN A. OBERLY
Counsel of Record
General Counsel
Ernst & Young LLP
787 Seventh Avenue
New York, New York 10019
(212) 733-2500

THOMAS L. RIESENBERG
Associate General Counsel
Ernst & Young LLP
1225 Connecticut Ave., N.W.
Washington, D.C. 20036

Counsel for Petitioner

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REPLY TO BRIEF IN OPPOSITION

In urging this Court to decline review, Respondents only underscore the need for intervention: the lower courts simply are not heeding the message of *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S.Ct. 1439 (1994), when it comes to interpreting the reach of primary liability under Section 10(b). Unless this Court takes action, the lower courts will continue to permit private plaintiffs to use Section 10(b) to avoid the express Section 18 remedy created for *precisely* this situation: when a defendant makes an allegedly false statement in an SEC filing that affects the market price of stock. 15 U.S.C. 78r. If allowed to stand, the Ninth Circuit's decision -- and others like it -- will force auditors and other professionals to defend actions brought in direct conflict with Congress' intent under Section 18 to require proof of *actual reliance*, and its intent under Section 10(b) to impose liability only for *primary*, and not secondary, conduct.

Congress wrote plainly in Section 10(b) that liability extends only to defendants who "use or employ" fraud "in connection with the purchase or sale" of securities. 15 U.S.C. 78j(b). The Ninth Circuit effectively removed those words of limitation and substituted an expansive foreseeability test crafted nearly thirty years ago in *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). With other courts doing the same -- as Respondents acknowledge -- the Ninth Circuit's approach is as entrenched in the federal case law as was "aiding and abetting" before this Court dislodged that theory in *Central Bank*.

Continued entrenchment means that the important issues of statutory construction presented here are unlikely to reach this Court in another case. Once a class action "fraud on the market" case is allowed to proceed beyond the pleadings,

defendants face overwhelming pressure to settle in order to avoid the risk of an enormous adverse judgment -- however small that risk may be.[1] It is only because the district court below dismissed the pleadings that this case is now on appeal, and if the entrenched case law in the Ninth Circuit and elsewhere is allowed to stand, it is unlikely that any other case will come to this Court. Plaintiffs' ability to misuse Section 10(b) to bring these actions in defiance of Congress' intent will thus be effectively insulated from appellate review.

Respondents make no attempt to defend the Ninth Circuit's statutory interpretation on the merits. Instead, they seek to divert attention from the real issues, suggesting that review is unwarranted because: (1) the Ninth Circuit supposedly followed the *Central Bank* methodology, (2) the Ninth Circuit ignored compelling legislative history that its decision nullifies Congress' intent under Section 18 (and, so, this Court should be equally unconcerned), and (3) the factual predicate is allegedly different from that on which the Ninth Circuit and the district court both based their decisions. These contentions are uniformly wrong and without merit.

First, rather than follow *Central Bank*'s methodology, the Ninth Circuit sidestepped it by looking at Section 10(b)'s language and the statutory structure *only* to answer a question that was never raised. The issue before the Ninth Circuit was whether an auditor "use[s] or employ[s]" its opinion "in connection with the purchase or sale of any security" when the auditor provides that opinion to a client, who in turn files it in an annual SEC Form 10-K. App. 3a. The Ninth Circuit did *not* analyze whether the plain language of Section 10(b)

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[1] Janet C. Alexander, *Do the Merits Matter? A Study of Settlements In Securities Class Actions*, 43 Stan. L. Rev. 497 (1991). *See Central Bank*, 114 S.Ct. at 1454-55.

reaches these facts. Nor did it attempt to discern in general what "use or employ . . . in connection with" means. Nor did it consider why Section 18 -- which Congress expressly adopted for just this situation -- should be disregarded. Rather, it dodged the real issues by addressing the irrelevant question of whether the text and structure of Section 10(b) limit liability to "actual traders." *See* App. at 9a-12a; Opp. Br. at 6. That question, however, is not, and never has been, presented in any argument of the parties.

The Ninth Circuit then leaped straight to *Texas Gulf Sulphur* and declared the Second Circuit's test of "reasonably calculated to influence the investing public" to be a "*natural*" substitute for Section 10(b)'s language "to use or employ . . . in connection with the purchase or sale of any security." App. 15a (emphasis added); Opp. Br. 7. *Texas Gulf Sulphur's* "reasonably calculated" test rested, however, on the Second Circuit's unabashed decision to advance presumed policy goals *without regard* to any disciplined reading of Section 10(b)'s text. *See* 401 F.2d at 858-59, 860-61; Petition, note 5. In net effect, the Ninth Circuit therefore gave *no* consideration to the text of Section 10(b) -- or to its structure in relation to Section 18 or other provisions of the securities acts -- in reaching its holding.

Second, Respondents suggest that this Court should not trouble itself with the Ninth Circuit's obliteration of Congress' intent to require proof of actual reliance under Section 18 because the Ninth Circuit did not see the problem; in any event, Respondents did not sue under Section 18. Opp. at i, 2, 11-12. The Ninth Circuit's decision to disregard nullification of Congress' intent under Section 18, however, is grounds for this Court to *grant* review, not to deny it. And the fact that Respondents did not sue under Section 18 only demonstrates the nullification: Respondents did not sue under Section 18 because they did not read or rely on any allegedly false SEC

filing. The Ninth Circuit's decision, allowing Respondents to avoid Section 18's actual reliance requirement by suing under Section 10(b), is in square conflict with Section 18's express language and Congress' intent.

Respondents have no logically coherent response to this problem because there is none. The Ninth Circuit effectively displaced Section 10(b)'s "in connection with" requirement with a foreseeability test: as long as it is foreseeable that a defendant's words will become public and affect the price of stock, a Section 10(b) claim is available. This construction makes *all* false statements in SEC filings actionable under Section 10(b) because *all* SEC filings are public and thus foreseeably affect the price of stock. Under the Ninth Circuit's decision, the actual reliance requirement of Section 18 will *never* pose a barrier to liability for false statements in SEC filings: a plaintiff who did not rely may claim simply that a false SEC filing affected the market price of stock -- *i.e.*, was a "fraud on the market" -- and sue under Section 10(b), as Respondents have done.[2] *See* Petition at 16-18.

The Ninth Circuit chose to ignore dispositive legislative history showing that its decision flies directly in the face of Congress' intent. In crafting the Securities Exchange Act of 1934, Congress, for the first time, imposed routine reporting

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[2] This is not a case, as Respondents suggest, of mere "overlap" between Section 10(b) and Section 18 which might be tolerated under current law. Opp. at 12, citing *Herman & MacLean v. Huddleston*, 459 U.S. 375, 383 (1983). Rather, it is a case in which an express limitation on liability is wiped out by an overly broad construction of the implied right of action under Section 10(b) -- a result which this Court has never tolerated. *Touche Ross & Co. v. Redington*, 442 U.S. 560, 573-75 (1979); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208-10 (1976). As previously noted, this Court has expressly reserved the issue of whether Section 18 provides an exclusive remedy for false statements in SEC filings. *Touche Ross*, 442 U.S. at 573.

requirements upon all publicly traded companies, including a requirement that such companies file audited financial statements. 15 U.S.C. 78m. In that same legislative plan, Congress enacted Section 18 to create, define, and limit liability for false statements in SEC filings. When drafting Section 18, Congress rejected an earlier version of the statute that would have created liability for *precisely* the conduct at issue here: when a defendant is alleged to have done nothing more than make a false statement in an SEC filing that affects the price of stock. S. 2693, 73d Cong., 2d Sess. §17(a) (1934). Congress *added* an actual reliance requirement to Section 18 to limit liability. It is *inconceivable* that Congress could have intended the courts to use Section 10(b) to create a loophole that would obliterate its intent in enacting Section 18.

Third, Respondents advance a factual contention noted previously only in a footnote of their reply brief to the Ninth Circuit -- *i.e.*, that Ernst & Young consented to inclusion of its audit opinion in certain of its client's stock registration statements. Opp. at 2, 4-5. This is a red herring. Respondents have never claimed -- nor could they -- that they bought securities pursuant to any registration statement containing Ernst & Young's audit opinion. This case is founded *entirely* upon inclusion of Ernst & Young's audit opinion in a routine annual SEC Form 10-K. App. at 3a-5a, 18a-24a. A Form 10-K does not contemplate the sale of particular securities as does a registration statement. *See* 15 U.S.C. 78l (stock registration). Indeed, the district court below so found: "Defendant's issuance of an audit report, *as set out in the pleadings before the court, included in the periodic disclosure filing, not in any offering document*, will not entitle plaintiffs to relief[.]" App. 33a (emphasis added).

Naturally, Respondents did not object to the district court's finding, nor raise any claim of error in the Ninth Circuit, precisely because this case is based purely on alleged

"fraud on the market" in after-market trading. The Complaint does not allege, nor could it, that Respondents purchased stock pursuant to any particular stock offering. *See* App. at 42a-55a (excerpts from the Complaint). Both the district court and the Ninth Circuit founded their opinions on this basis. *See* App. App. 3a-5a (Ninth Circuit); 18a-23a (district court).[3] No credence should be given to Respondents' effort to muddy these clear waters.

The issue of what it means for a defendant to act "in connection with" a purchase or sale of securities under Section 10(b) will never be more ripe for review than it is today. This Court has accepted review of the Eighth Circuit's decision in *United States v. O'Hagan*, No. 96-842, which also presents interpretation of the "in connection with" requirement. Although Respondents describe *O'Hagan* in footnote as having "nothing to do with this case" (Opp. at 11 n.5), the SEC -- writing on behalf of Respondents as *amicus curiae* in the Ninth Circuit below -- took pains to flag the relevance of *O'Hagan* in a post-briefing letter to that court.[4]

In this Court, the American Institute of Certified Public Accountants has filed briefs as *amicus curiae* both in *O'Hagan* and in this case. As the Institute rightly points out, consideration of the "in connection with" language in light of

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[3] *If* this had been a false registration statement case, then Respondents -- who are represented by one of the best known securities class action firms in the country -- would have sued under Section 11 of the 1933 Securities Act, 15 U.S.C. 77k. Section 11 imposes liability based on a negligence standard and requires only a minimal burden of proof by plaintiffs. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 388 (1983).

[4] The SEC wrote, "[t]his decision [by the Eighth Circuit] contains a discussion of the interpretation of the 'in connection with' requirement of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), which is the issue presented in [this] appeal." Supp. App. 56a.

different factual circumstances may assist the Court to discern a consistent meaning that can be applied by the lower courts in all Section 10(b) cases. Brief of AICPA at 2, *United States v. O'Hagan* (No. 96-842).[5]

Finally, as noted above, the important issues of statutory construction presented in this Petition are likely to evade future review. In the immediate wake of *Central Bank*, the district court below was the first in decades to read the "in connection with" requirement plainly in a "fraud on the market" case. The Ninth Circuit's reversal assures that no district court within its jurisdiction will do so again -- and reduces the odds that any district court anywhere will do so. To the extent that cases such as this are allowed to proceed past the pleadings, they are unlikely to reach appellate review. *See* pages 1-2, note 1, *supra*. The risk of an enormous, adverse judgment in these cases creates a coercive settlement environment that few defendants can afford to withstand. *See Central Bank*, 114 S.Ct. at 1454 ("'Litigation under 10b-5 presents a danger of vexatiousness different in degree and kind from that which accompanies litigation in general.'" Citation omitted.)

In short, unless this Court intervenes now, the issues presented in Ernst & Young's Petition may not reach the Court

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[5] One issue in *O'Hagan* is whether the defendant's misappropriation constitutes a "manipulative or deceptive act" under Section 10(b). But irrespective of how that issue is decided, the statute requires -- as a *separate* element of proof -- that the defendant "use or employ" the conduct "in connection with the purchase or sale of any security." In construing this element of liability, the Eighth and Ninth Circuits reached incongruous results. The Eighth Circuit held that a defendant who actually traded particular securities based on his alleged wrongdoing did *not* act "in connection with" the purchase or sale of any security, while the Ninth Circuit held that Ernst & Young, who merely provided an audit opinion to its client, *did* act "in connection with" the purchase or sale of stock.

in another case. Contrary to Respondents' contention, that does *not* mean the issues are unimportant; indeed, review in this case is essential to protect defendants from extortionate settlement demands in lawsuits that Congress never authorized. Absent review, Congress' legislative plan will be flouted: the lower courts will continue to allow private plaintiffs to use Section 10(b) to thwart the express limitations of Section 18 and to impose unintended primary liability upon accountants, attorneys, and other professionals who play only secondary roles in our nation's securities markets.

For the foregoing reasons and those set forth in Ernst & Young's petition, a writ of certiorari should be granted.

Respectfully submitted.

MILES N. RUTHBERG
PAMELA S. PALMER
Latham & Watkins
633 West Fifth Street
Suite 4000
Los Angeles, CA 90071

KATHRYN A. OBERLY
Counsel of Record
General Counsel
Ernst & Young LLP
787 Seventh Avenue
New York, New York 10019

THOMAS L. RIESENBERG
Associate General Counsel
Ernst & Young LLP
1225 Connecticut Ave., N.W.
Washington, D.C. 20036

Counsel for Petitioner

MARCH 1997

SUPPLEMENTARY APPENDIX

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
450 Fifth Street, N.W., Mall Stop 6-5
Washington, D.C. 20549

AUGUST 5, 1996

BY FACSIMILE (without attachment)
and FEDERAL EXPRESS

Office of the Clerk
United States Court of Appeals
for the Ninth Circuit
125 South Grant Ave.
Pasadena, CA 91105
Attn: Lucy Norell

Re: McGann v. Ernst & Young LLP, No. 95-55925

Dear Ms. Norell:

The above-referenced case, in which the Securities and Exchange Commission is participating as amicus curiae, is scheduled to be argued on August 7, 1996 in Courtroom 1 before Judges Fletcher, Tashima, and Restani. Pursuant to Rule 28(j) of the Federal Rules of Appellate Procedure, I enclose a copy of a recent decision of the United States Court of Appeals for the Eighth Circuit, United States v. O'Hagan, No. 94-3856 (8th Cir. August 2, 1996) (available on WESTLAW at 1996 WL 431180). This decision contains a discussion of the interpretation of the "in connection with" requirement of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), which is the issue presented in the McGann appeal. See 1996 WL 431180 at *6-*8.

If you have any questions, please call me at (202) 942-0933.

Sincerely,

Randall W.Quinn
Senior Litigation
Counsel

Attachment
cc: Leonard B. Simon
Kevin J. Yourman
Alison M. Tattersall
Michael P. Fuchs
Joseph H. Weiss
Miles N. Ruthberg
Eugene R. Erbstoesser
Kathryn A. Oberly